

MEMORANDUM

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FILE NO.: 61308-1

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LOCAL: 4103.298.3318

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CLIENT: State of Alaska

RE: Rolled-in vs. Incremental Tolls

The following provides a brief overview of the rolled-in versus incremental (stand-alone) toll issue and the principles generally applied by the National Energy Board ("NEB" or "Board") in making such rate-making decisions. Specific reference is made in this regard to the Board's Reasons for Decision in GH-2-87, TransCanada Pipelines Limited Applications for Facilities and Approval of Toll Methodology and Related Tariff Matters ("GH-2-87") and Reasons for Decision in GH-5-89, TransCanada Pipelines Ltd. Application Regarding Tolling and Economic Feasibility ("GH-5-89"). These decisions reflect the most recent consideration of this issue in the context of a major mainline pipeline expansion and the approach adopted by the Board has been applied consistently since that time.

1.0 CONCLUSION

The *National Energy Board Act* and regulations do not deal specifically with the issue of rolled-in versus incremental tolls. Nor has the Board issued a specific "generic" policy dealing with this issue. Guidance can, however, be gleaned from past decisions in which the Board has considered the matter. While the Board is not bound by past decisions and therefore will address the issue of tolling methodology on a case-by-case basis, it has tended to consistently apply certain principles in rendering its decisions with respect to major facility or system expansions. In so doing, the Board has typically favoured a "rolled-in" methodology, in the interests of fairness, equity and simplicity, and in view of its approach to pipelines as integrated systems.

Under a rolled-in methodology, costs of new facilities are added to existing costs, and tolls for all traffic are based on the costs of the system, including the expansion. In contrast, under an incremental approach, new volumes are allocated a different toll from that applied to existing volumes: the toll assigned to the new volumes may be based only on the new facilities, or on the new facilities plus their proportional share of the existing systems.¹

¹ Canada Energy Law Service, Vol. 1, para. 171.

In providing the views herein we would distinguish the circumstances surrounding a mainline expansion from the construction of a pipeline lateral or extension, which may be built for specific end-users. In such circumstances, the NEB has previously allocated the costs of the specific facilities to the identifiable end-users. This is not viewed as being inconsistent with the general application of "rolled-in" principles.

2.0 ROLLED-IN METHOD OF COST ALLOCATION AND TOLL DESIGN

Two decisions in particular, Decision GH-2-87 and Decision GH-5-89, serve to illustrate the manner in which the NEB has approached the toll methodology issue. A summary of each is provided below.

a. GH-2-87

GH-2-87 involved a facilities application by TCPL. TCPL had specifically applied for new facilities to expand the capacity of its pipeline system in order to serve existing markets and to deliver additional export volumes to the northeastern United States. In setting down TCPL's facilities application for hearing, the Board decided to address at the same time any related toll methodology issues. It is noted that the decision of the Board in this regard is in keeping with the views expressed by it earlier in respect of an application by IPL for new tolls effective January 1, 1987 (see: NEB Decision RH-4-86).

Toll methodologies considered by the Board in GH-2-87 included the rolled-in and incremental methodology. Under the prevailing rolled-in methodology, the cost of the new facilities would be added to the existing rate base and the tolls for all traffic, including the new volumes, would be based on the new cost of service for the whole pipeline system including expansion. To the extent that the toll revenues generated by the new volumes were greater (or less) than the costs of owning and operating the new facilities, the new tolls, on a rolled-in basis, would be lower (or higher) than the existing tolls (page 68).

With respect to the incremental methodology, two distinct approaches were examined. Under the first incremental approach, the tolls for the new volumes would be charged with only the costs of the new facilities needed to expand capacity to move them through the system. Under this approach, existing tolls would remain unchanged and in effect, no charge would be made for the use of existing facilities although new volumes would make use of them to the extent that spare capacity was available.

Under a second incremental approach, referred to as the "alternate incremental" approach, new volumes would be allocated their proportional share of the existing system costs plus all the costs of the new facilities. Using this approach, the toll for the existing system would decline due to higher overall throughput but the new volumes would be charged with a higher aggregate toll (page 68).

Ultimately, the Board determined that the rolled-in method of cost allocation and toll design would be appropriate in respect of the authorized facilities. In arriving at its decision, the Board looked at both practical and legal considerations, including:

- fairness and equity
- the integral natural of the system,
- complexity/simplicity
- the just and reasonable standard; and
- unjust discrimination

With respect to fairness and equity, the Board considered the legitimacy of the claims of the existing shippers over those of the so-called new shippers. In so doing, it made clear that existing shippers do not possess "acquired rights" to enjoy the use of the older facilities at lower embedded costs. Rather, "[i]n the Board's view, the payment of tolls in the past conferred no benefit on tollpayers beyond the provision of services at that time. The Board does not equate those who paid for a service with those who paid for the facilities" (page 70). Accordingly, the Board placed existing and new shippers on the same footing and rejected the notion that shippers who have used the pipeline in the past are entitled to continue using the existing facilities without being affected by new circumstances.

Significantly, the Board also endorsed the concept of TCPL as an integrated system, noting that the new facilities contributed to the capacity and integrity of the system as a whole. Therefore, the Board determined that there was no reason to deviate from the historical treatment with capital costs rolled into one rate base and for tolls to be charged on a rolled-in basis. The Board specifically noted, however, that this finding "does not prevent other facilities, such as those designed to deliver extra pressure, from being treated either on a rolled-in or an incremental basis" (page 71).

With respect to complexity/simplicity, the Board recognized that the rolled-in approach avoids the toll design complexity inherent in an incremental approach. Therefore, it did not find it practical to require TCPL to divide the existing system into component parts or multiple incremental rate bases (i.e. create two rate bases: domestic and export).

Turning to legal considerations and specifically the need for just and reasonable tolls that are not unjustly discriminatory (ss. 52 and 55 NEB Act) the Board found (page 73):

To the extent that the new facilities form part of the integrated system, the Board agrees with those parties to the hearing who submitted that section 52 precludes the adoption of an incremental toll methodology. Each of the alternate and the incremental methodologies would afford different, segregated treatment to new facilities and cost of service components required to deliver all, or a portion of, the incremental volumes. This would result in different tolls being paid for the same service to the same zone and even to the same delivery point, and would, in the Board's view, violate section 52.

[Emphasis added.]

The Board also noted however that a finding, in the circumstances of this case, that the integrated nature of TCPL precludes the adoption of other than a rolled-in methodology does not necessarily mean that all new facility additions must be treated in a similar manner. If the services had been required by only a limited number of shippers and the facilities could be separately identified from the integrated rate base, then the principles of cost-causation and "user pay" would likely apply to guard against undue cross subsidization by other shippers. In other words, under different circumstances, the provision of additional delivery pressure at any delivery point could be recovered through stand-alone tolls (page 73):

When identifiable facilities which do not increase the throughput capacity on the integrated system are installed to provide a customer service to a specific user or group of users, then such discrete facilities might not form part of the integrated system. In such cases, these facilities can, in the Board's view, be the subject of a separate toll, calculated on the basis of either a rolled-in or incremental methodology; this would not constitute a contravention of section 52 of the Act.

[Emphasis added.]

This suggests that a key consideration for the Board in determining toll methodology concerns whether the proposed expansion relates to the integrated system as a whole (eg. mainline expansion) as opposed to serving a specific user or group of users.

b. GH-5-89

The appropriateness of rolled-in tolls surfaced again in the GH-5-89 proceeding in which the Board considered TCPL's application for 1991 and 1992 facilities. Specifically before the Board was the issue of the toll treatment of the capital and operating costs of the proposed facilities including an examination of rolled-in and incremental tolls. The magnitude of the proposed expansion (\$2.6 billion – double TCPL's rate base) was a common concern of those proposing alternative toll methodologies.

In the Decision, the Board once again opted for rolled-in tolls. In so doing, the Board noted that the magnitude of the expansion did not justify changing the methodology nor did the riskiness of the market. In this regard, it stated that "[w]hile factors such as the size, cost or impact on tolls of the proposed facilities may be relevant to the Board's decision on whether to authorize construction of the facilities, they do not in this case justify discriminating among shippers on the basis of when they commenced, or will commence paying tolls and receiving service". The Board also reaffirmed its findings in GH-2-87 that the previous toll-payers have no "acquired rights". Therefore, "they cannot expect to be exempted from a toll increase simply because they have paid tolls in the past".

The Board went on to reiterate its view that pipelines are integrated systems and that, on completion, the proposed facilities would be integral to the TCPL system. The facilities would not be associated with or dedicated to any individual shipper's gas. Given the Board's views on the integrated nature of the system, it found it would not be appropriate to authorize the use of flexible tolls only for certain volumes.

In terms of cost causation, the Board found that "the aggregate demand of all shippers that gives rise to the need for additional pipeline capacity". The Board also looked at economic efficiency, noting that it was not convinced that incremental tolling would provide significant improvements in economic efficiency over rolled-in tolls. Accordingly, the Board concluded that all facilities were to be rolled in to TransCanada's rate base for toll purposes.

The Board has since stated on numerous occasions that it supports the principles set out in the GH-5-89 decision and pipelines have generally been regulated as integrated systems under a rolled-in methodology.

There are however some exceptions. An example of this is the treatment of Interprovincial Pipe Line (IPL) Sarnia-Montreal oil pipeline extension in respect of which the Board ruled that (Canada Energy Law Service, Vol. 1, para. 171):

...the conceptual approach for setting rates for the extension should be "add on" (or incremental) rather than "rolled in", so that the Montreal extension was treated as a separate system for rate-regulation purposes.² The Board found that the decision to construct the extension was not based on normal economic grounds. This was shown by the federal policy of moving western Canadian crude to the Montreal market. Interim subsidization by the federal government of transportation costs beyond Toronto, and the fact that the pipeline was entirely debt-financed. *Had the construction been based on normal economic grounds, there would have been more cogent reasons to adopt a rolled-in approach.*

[Emphasis added.]

As stated above, this Decision is not seen as being inconsistent with the general application of the rolled-in toll methodology.

² Interprovincial Pipe Line Ltd. Rate Application, Reasons for Decision, December 1976, at 5-4 to 5-6.